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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

	)	
Notice of Market Dominant	)	Docket No. R2013-1
Price Adjustment	)	

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
COMMENTS ON THE UNITED STATES POSTAL SERVICE
NOTICE OF MARKET-DOMINANT PRICE ADJUSTMENT
(November 1, 2012)

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TABLE OF CONTENTS

INTRODUCTION

On October 11, 2012, the U.S. Postal Service filed a Notice of Market-Dominant Price Adjustment ("Notice") with the Postal Regulatory Commission pursuant to 39 U.S.C. § 3622, the Postal Accountability and Enhancement Act ("PAEA"), Public Law 109-435, and the Commission's rules promulgated thereunder (*see* 39 C.F.R. §§ 3010.1, *et seq.*). The CPI price cap applicable to this price adjustment is 2.570 percent, and price adjustments will take effect on January 27, 2013. This is the fifth general, non-exigent, pricing increase noticed by the Postal Service, following Docket Nos. R2008-1, R2009-2, R2011-2, and R2012-3.

On October 15, 2012, the Commission issued Order No. 1501, opening this docket and setting October 31, 2012 as the deadline for public comment. This date was extended to November 1, 2012 by Order No. 1522. These comments are filed jointly on behalf of Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak"). Pursuant to Rule 3010.13(b), these comments focus on compliance of noticed prices with the requirements, factors, objectives, and policies of Title 39.

The Commission and the Chairman have issued important information requests seeking to better understand and expose problems associated with the Postal Service's pricing for Standard Mail Flats.[1]

On October 22, 2012, Valpak filed a Motion to Strike Standard Mail Price Adjustment from United States Postal Service Notice of Market-dominant Price Adjustment.[2] The Postal

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1 *See, e.g.*, Commission Information Request, No. 1 (October 18, 2012). http://www.prc.gov/Docs/85/85378/CIR_No_1.pdf.

2 http://www.prc.gov/Docs/85/85405/Motion%20to%20Strike%20Stan%20Mail%20Prices.pdf.

Service's opposition to Valpak's motion was due on October 29, 2012, but was filed on October 31 due to the government's two-day closing for Hurricane Sandy. The Commission has not yet ruled on Valpak's Motion.

COMMENTS

I. POSTAL SERVICE FINANCES CONTINUE TO DETERIORATE, NECESSITATING A THOROUGH REVIEW OF POSTAL SERVICE PRICING IN THIS DOCKET.

Recent Postal Service financial developments in the sixth year of the PAEA regimen (FY 2012) have made the first five years seem successful by comparison. Despite aggressive cost cutting within the strict constraints of existing law, through August 2012 (the eleventh month of FY 2012), the agency reports that it had lost nearly $2.0 billion, exclusive of Postal Service Retiree Health Benefit Fund ("PSRHBF") expenses and workers compensation noncash adjustments.[3] Although product specific revenue and cost information for FY 2012 will not be available until the Postal Service files its Annual Compliance Report on or about December 29, 2012, perhaps 25 to 30 percent of total operating losses are due to the Postal Service's continuing underpricing of just one product — Standard Flats.

On August 1, 2012, the Postal Service defaulted on its PAEA-mandated payment of $5.5 billion to prefund retiree health benefits. (That payment originally had been due on September 30, 2011, but was deferred by Congress.) On September 30, 2012, the Postal

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[3] The Postal Service terms these "Controllable Operating Losses." *See* USPS Preliminary Financial Information (unaudited), August 2012 (Sept. 26, 2012). http://www.prc.gov/Docs/85/85225/2012%209%2025%20August%20FY2012%20Financial%20Summary%20to%20the%20Govs.pdf.

Service, for the second time in two months, defaulted on another installment of that obligation, this time for $5.6 billion.[4] At the end of September 2012, the Postal Service, for the first time in its history, hit its statutory $15 billion borrowing limit from the U.S. Department of the Treasury.[5] Together, these obligations total $26.1 billion, and an additional $5.6 billion PSRHBF payment will be due at the end of September 2013.

Against this backdrop, on October 11, 2012, the Postal Service gave notice of permissible price adjustments under PAEA, which do no more than allow the Postal Service to keep current under a formula based on one government-measure of price inflation (CPI-U) — now 2.570 percent. Clearly the Postal Service's September 26, 2012 statement is correct: "Comprehensive reform of the laws governing the Postal Service is urgently needed in order for the Postal Service to … return to long-term financial stability."[6] By the time the Postal Service files its FY 2012 Annual Compliance Report with the Commission in late December 2012, the lame duck session likely will have concluded, and we will know if Congress will have tempered, or even undone, some of the more restrictive provisions of PAEA, allowing the Postal Service to cut costs more effectively and removing crippling financial burdens.

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[4] *See* "Postal Service Statement on Sept 30 Retiree Health Benefits Prefunding Payment" (Sept. 26, 2012). http://about.usps.com/news/national-releases/2012/pr12_0930rhbpayment.htm.

[5] *See* E. Morath, "Postal Service Hits Borrowing Cap for First Time" (Oct. 16, 2012). http://online.wsj.com/article/SB10000872396390443675404578060850778951388.html.

[6] *See* "Postal Service Statement on Sept 30 Retiree Health Benefits Prefunding Payment," *supra*.

Of course, neither cost cutting nor the financial burdens associated with covering future retiree health benefit costs are issues before the Commission in this docket, but the Postal Service's pricing strategies certainly are. With Congressional constraints on many approaches to postal cost cutting and the Postal Service being forced to live under a price cap regimen, intra-class pricing is one of the most important tools in the Postal Service's arsenal to improve its financial condition.

During the four prior general cap-based price adjustments since enactment of PAEA, the Commission has engaged in a minimalistic review of Postal Service pricing. During that period, as demonstrated in Section III, *infra*, the Postal Service has used its much-vaunted pricing flexibility to choose to lose over $2 billion on Standard Flats alone. Including FY 2012, the cumulative losses on Standard Flats under PAEA will almost certainly exceed $2.5 billion. The additional losses the Postal Service sustains from Periodicals[7] are largely beyond its control, but that cannot be said for Standard Flats. Having dissipated its assets and exhausted its borrowing power, the only way the Postal Service can make up for these continued losses from its flawed pricing strategy is by shifting the burden of Standard Flats losses onto the backs of other Standard Mail users.

Thus, the problem is not limited to Standard Flats pricing, but spills over to include all Standard Mail pricing. Shifting Standard Flats losses to other Standard Mail products causes

[7] The Postal Service lost $2.747 billion from Periodicals between FY 2007 and FY 2011 under PAEA — with $609 million of those losses in FY 2011 alone, giving the class a cost coverage of 75 percent. *See* Docket No. ACR2011, Valpak Initial Comments, Table V-1. The Postal Service's noticed price adjustments for the Periodicals class in this docket use all except the last 0.01 percent, but there never will be a way that PAEA cap-limited price adjustments alone will enable Periodicals to cover its costs.

reductions in the volume of and contribution from high-profitability products, such as saturation mail.[8] All Standard Mail is advertising, and one would assume that similar mail would have somewhat similar coverages, but Postal Service coverage by product varies widely — from well below cost at 79.3 percent for Standard Flats to above double cost at 220.0 percent for High Density/Saturation Letters. Products with high elasticity would ordinarily be expected to have lower price increases and lower coverages, but the opposite is true. These peculiar results of Postal Service "pricing flexibility" as they existed in the last complete fiscal year, FY 2011, are shown in Table 1. The Commission has already ordered the Postal Service to increase prices for Standard Flats and eliminate cross subsidies, and it is urged that the Commission again use statutory tools to bring rationality to Postal Service pricing, using its powers with increasing vigor.[9]

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[8] As shown in Table 1, the FY 2011 coverage of High Density/Saturation Letter was 220.0 percent, and the coverage of High Density/Saturation Flats & Parcels was 213.0 percent.

[9] Without explaining its no doubt rosy assumptions, the Postal Service projects losses on Standard Flats of $649 million, $462 million, and $340 million for FY 2011-13, respectively. The cumulative loss for those three years alone amounts to $1.45 billion with no indication when the product will break even. Response to CIR No. 1, spreadsheet Standard Mail Flats Response to CIR No. 1, tab PCCM FY 11-13.

Table I

FY 2011, Standard Mail Product Cost Coverages and Elasticities by Former Subclass

Product	Cost Coverage	Commercial Elasticity
Former Regular Subclass:		
Regular Letters	183.6%	0.335
Regular Flats	79.3%	0.335
Regular NFMs/Parcels	84.8%	0.335
Former ECR Subclass:		
HD/Sat Letters	220.0%	0.782
HD/Sat Flats/Parcels	213.0%	0.782
Carrier Route	134.8%	0.782
Standard Class Weighted Average	147.6%	

Source: Coverages from USPS-FY11-1; Elasticities from Docket No. ACR2011, Valpak Initial Comments, Table II-1.

At minimum, Valpak asks the Commission to reject the Postal Service Standard Mail prices as they violate the Commission's prior orders, ordering the Postal Service to implement lawful prices, as discussed in Section II, *infra*.

However, the Postal Service's flat refusal to comply with the Commission's remedial orders has been accompanied by a continuing challenge to the Commission's authority over pricing. The Postal Service states that it "alone has the authority to establish reasonable and equitable rates of postage pursuant to section 101(d) and 404(b) of Title 39 U.S.C." Postal Service Response to Valpak Motion to Strike, p. 2. "[T]he Postal Service acknowledges that it did not give Standard Mail Flats an above-average CPI-U increases," claiming that its pricing in this docket balances "the need to improve the cost coverage for Standard Mail Flats pursuant to the Commission's order, and the need for the Postal Service to increase contribution in order to remain economically viable." *Id.*, p. 5. The Postal Service wants the benefit of the monopoly protection from competition with no regulatory oversight over mandating unfair cross-subsidies through pricing, violating the PAEA construct. It is worth re-examining the scope of the Commission's charter in reviewing the Postal Service's noticed price adjustments.

PAEA established a "modern" system for setting prices for market-dominant products, with a few "requirements," 14 "factors," and nine "objectives" (39 U.S.C. § 3622), including assuring "adequate revenues, including retained earnings, to maintain financial stability." 39 U.S.C. § 3622(b)(5). Until now, the Commission has focused on three aspects of a Postal Service filing in a price adjustment docket: (i) the noticed prices being within the price cap; (ii) a justification for workshare discounts that exceed avoided costs; and (iii) compliance with provisions governing reduced rate mail. However, Commission rules are more broad and also require that the Postal Service notice contain a "discussion that demonstrates how the planned rate adjustments are designed to help achieve the objectives … and properly take into account the factors…" of PAEA.[10] *See* PRC Rule 3010.14(b). Previously, the factors and objectives in section 3622(b) and (c) have been described by the Commission as qualitative in nature, and not easily susceptible to the Commission's review in the short time allotted for review of price adjustments.[11] Consequently, price adjustment reviews have paid scant attention to the factors,

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[10] Factor (c)(12) requires the Commission to consider the policies of Title 39.

[11] "When the Postal Service proposes changes to market dominant rates, the changes are subject to scrutiny by the Commission for compatibility with these

objectives, and other polices of Title 39, such as 39 U.S.C. §§ 101(d) and 403(c). Although this has been the practice thus far, there is no provision in the statute or the rules mandating that approach, particularly when there has been Postal Service defiance of the Commission's remedial orders and extraordinary financial reasons for the Commission to take a more proactive approach.

Indeed, if there were ever a time for the Commission to act to help the Postal Service with its pricing, it would be now. Unless operating revenues exceed operating costs in the near future, the Postal Service could run out of cash as early as March 2013.[12] The Postal Service stated in its response Valpak's Motion to Strike that its "'financial stability' … has never been at greater risk."[13] The Postal Service certainly has not set intra-class prices to achieve objective number (b)(5) — "To assure adequate revenues, including retained earnings, to maintain financial stability." When the Postal Service is on the verge of running out of money, the Commission can no longer limit its review to three criteria, none of which has a significant effect on revenue adequacy. Rather, for each class of mail, the Postal Service needs

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qualitative standards. This scrutiny, however, is **typically light, since it must be concluded in the very short time frame** required by statute. Consequently, reviewing market dominant rates for consistency with the PAEA's many qualitative pricing standards is largely deferred by the Commission until after-rates are implemented, in its Annual Compliance Determination. See 39 U.S.C 3653." Docket No. RM2009-3, Order No. 536, p. 17 (emphasis added). http://prc.gov/Docs/70/70204/Order_No_536.pdf.

[12] "USPS … acknowledged that cash flow will be a particular concern in the second half of fiscal 2013." "Regulatory: No imminent cash crunch at Postal Service," FedLine, Federal Times (Oct. 23, 2012).

[13] USPS Response to Valpak Motion to Strike (Oct. 31, 2012), p. 7.

to maximize contribution within the rate cap. At least for Standard Mail, the Postal Service has failed to do so by a wide margin.[14]

II. THE POSTAL SERVICE'S NOTICED STANDARD MAIL FLATS PRICES ARE ILLEGAL.

In Docket No. ACR2010, the Commission found the Postal Service's Standard Flats pricing was illegal,[15] and the Postal Service's noticed Standard Mail prices under review are in violation of those prior Commission Orders, 39 U.S.C. § 101(d), and PAEA. This is the only time under PAEA the Commission has found a violation, and yet the Postal Service has resisted the Commission's statutory authority in every way and at every turn. Valpak's position on this issue is set out in its Motion to Strike Standard Mail Price Adjustment from United States Postal Service Notice of Market-dominant Price Adjustment, filed October 22, 2012.[16] To avoid repetition, and as the Commission has not yet ruled on Valpak's Motion, Valpak incorporates by reference into these comments the arguments advanced in support of its Motion to Strike, adding only a few additional comments.

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[14] As the Postal Service seeks financial relief from Congress, it ought to be prepared to give Congress a full explanation as to why taxpayers should be on the hook to cover cumulative losses on account of deliberate pricing policies that repeatedly have not just missed an opportunity, but instead have even abused the Postal Service's pricing flexibility, imposing on the Postal Service billions of dollars of losses. *See* Section III, *infra*.

[15] *See* FY 2010 ACD, pp. 103-07.

[16] http://www.prc.gov/Docs/85/85405/Motion%20to%20Strike%20Stan%20Mail%20Prices.pdf.

First, the magnitude of the losses on Standard Flats continues to be staggering, both on an aggregate basis ($643.2 million) and on a unit basis (9.6 cents) in FY 2011. Yet the Postal Service continues to ask the Commission to kick the can down the road, still one more time.

Table 2

Revenue and Cost of Standard Flats
FY 2011

	Total (000)	Per Piece
Revenue	$2,499,669	$0.368
Cost	3,142,862	0.463
Loss	-643,193	-0.095

Source: FY 2011 ACD, p. 112.

Second, illegal pricing is not a victimless crime. The Postal Service's response to Valpak's motion asserts that "Valpak's motion is intended to service Valpak's own interest…" implying that Valpak's position must yield to the greater good of Postal Service financial stability. When the Postal Service artificially reduces Standard Flats prices below cost and chooses to lose money on that product, it must artificially increase prices for other Standard Mail products. The Postal Service transfers the greatest burden of the subsidy by imposing its highest coverage on High Density/Saturation Letters — 220 percent — the primary product that Valpak purchases. When the victim of illegal Postal Service pricing complains, the Postal Service urges the Commission to stop its ears. Valpak wishes the Postal Service were setting postal prices in the Postal Service's own interest, but the Postal Service has demonstrated it refuses to price like a business and refuses to follow the mandates of PAEA, including establishment of reasonable and **equitable** prices.

In its review of the last general pricing adjustment (Docket No. R2012-3), the Commission expressed its twin concerns: the "Postal Service's planned rates do little to remedy the intra-class subsidy of Standard Mail flats;" and "the lack of explanation provided by the Postal Service as directed in FY 2010 ACD." Order No. 987 (Nov. 22, 2011), pp. 32-33. Apparently due to the then-pending "appeal of the Commission's 2010 ACD," the Commission was willing to postpone these issues until "the coming Annual Compliance Determination … how Standard Mail Flats are moving toward compliance, and how its pricing reaches that goal" and allow Standard Mail rates to go into effect. Of course, that appeal was still pending when the FY 2011 ACR was considered, and no other remedial steps were then ordered in Docket No. ACR2011.

However, the appeal is now over and the Commission should require the Postal Service to comply with its orders.[17] Indeed, PAEA states that the Commission is required, after a "written determination of noncompliance" (which occurred on March 29, 2011, in Docket No. ACR2010) to "take appropriate action in accordance with subsections (c) and (e) of section 3662." 39 U.S.C. § 3653(c). PAEA's remedial powers set out in section 3662(c) require the Commission to order the Postal Service to:

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[17] There is no question Congress gave the ultimate power over unlawful rates to the Commission, not the Postal Service. Indeed, Congress even equipped the Commission with the power to address Postal Service pricing noncompliance with injunctive relief and imposition of fines. *See* 39 U.S.C. §§ 3662(d) and 3664.

> take such action as the Commission considers appropriate in order [i] to **achieve compliance** with the applicable requirements **and** [ii] to **remedy the effects of any noncompliance** (such as ordering **unlawful rates** to be **adjusted** to lawful levels [or] ordering the Postal Service to **discontinue** providing **loss-making products**.... [Emphasis added.]

The Commission should reject the noticed prices for Standard Flats as not being compliant with its order in the FY 2010 ACD and subsequent orders. As this pricing is a violation of a prior Commission order issued pursuant to 39 U.S.C. § 3662(c), the Commission is not bound by the limitations for rejecting a price adjustment under section 3622(d)(1)(C)(ii). Since the Postal Service has not engaged in good-faith compliance, it is urged that the Commission determine that the noticed prices are illegal and order new Standard Mail prices which give a significant and immediate and significant increase to Standard Flats prices.

The Commission has the authority to remedy prior noncompliance, and it is submitted that it now has the duty to order corrective action without further delay. With the appeal concluded and the Postal Service's continuing refusal to comply, there would be no reason for the Commission to wait until its Annual Compliance Determination for FY 2012 to order full compliance, and to remedy the effects of noncompliance. Although it is true that postponement would result in a delay of only a few months (the Postal Service's Annual Compliance Report being due by December 29, 2012), postponement could have an adverse consequence in creating a situation where there could be two Standard Mail price adjustments within relatively quick succession in early 2013:

- the Docket No. R2013-1 noticed adjustment, scheduled to go into effect on January 27, 2013, followed by;
- a Docket No. ACR2012 mandated adjustment, to go into effect later in 2013.

It would be more efficient and less burdensome on the mailing community if the Commission addressed this problem at one time — now — in line with PAEA's objective of achieving "predictability and stability in rates." 39 U.S.C. § 3622(b)(2).

Valpak has never argued for the entire amount of losses on underwater products to be made up at one time. However, as the Postal Service procrastinates, it is more and more difficult to wait for fair and equitable rates to be implemented. According to the Postal Service's projections in response to Commission Information Request No. 1, if Standard Mail products receive approximately the same increases as the Postal Service proposes, the gap in coverage between the products is maintained and unfairness will continue. Valpak urges the remedial prices to achieve full cost coverage in no more than two annual steps. This would be to require a $0.05 average price increase for Standard Flats, which would make up slightly more than half of the –$0.096 per-piece contribution as reported in FY 2011 ACD, p. 117. That would constitute about a 13.6 percent average price increase. The Postal Service optimistically believes that there will be a small Standard Flats unit cost savings of $0.005 from the Network Rationalization. *See* Response of Postal Service to Commission Information Request No. 1, Question 2 (Oct. 23, 2012). If that happens, so much the better, but the price increase ordered by the Commission should get the Postal Service to breakeven on Standard

Flats within no more than two annual steps — the first being with the next change in Standard Mail rates in January 2013.

Accordingly, Valpak submits that the Commission now should:

- Find that the noticed Standard Mail Flats prices were *prima facie* not in compliance with prior orders;
- Declare unlawful the Standard Mail price adjustments noticed by the Postal Service on October 11, 2012; and
- Direct the Postal Service to increase the average price of Standard Flats by at least $0.05, with any remaining Standard Mail cap space used in a way which would maximize contribution from the class.

According to Commission Rule section 3010.14, once the Commission strikes the Postal Service's noticed rates, or otherwise finds them "inconsistent with applicable law," the Postal Service must submit an amended notice. The Commission posts that notice and allows a period of 10 days from the date of filing for public comment, and 14 days for the Commission to issue an order announcing its findings. If the planned rate adjustments as amended are found by the Commission to be consistent with applicable law, they can take effect, so long as the public has 45 days notice (which would require Postal Service action by December 13, 2012, to maintain a January 27, 2013 implementation date). PAEA grants the Commission power to find the Postal Service prices illegal and order compliance with prior orders, and Valpak asks the Commission to take this next step.

III. THE POSTAL SERVICE'S STANDARD MAIL CONTRIBUTION MODEL IS BADLY FLAWED.

The Postal Service apparently believes that it is free to disregard the prior Commission's order finding noncompliance and above-average price increases for Standard Flats because the Commission's explanation on remand from the Court of Appeals (Order No. 1427), identified the factors that it "would consider before making such a finding" of a violation of 39 U.S.C. § 101(d). Since the Postal Service believes "significant price increases to Standard Mail Flats would be counterproductive...." in this docket, the prior Commission order is not considered to be binding. Postal Service Response, p. 5. In effect, the Postal Service disregards the Commission's prior findings and remedial orders as open to challenge in this docket, even though the Commission's actions were sustained by the Court, and the Postal Service here bases its deliberate refusal to comply on the same rationale that was previously rejected by the Court. *See* Valpak Motion to Strike, p. 9. Such a theory would render nonbinding every Commission remedial order.

Valpak does not believe the Commission should allow the Postal Service to relitigate these issues, but should the Commission choose to reconsider the matter, we address the Postal Service's argument.

In its filing justifying an (allegedly) average price increase for Standard Flats,[18] in direct defiance of prior Commission orders, the Postal Service presents a model which

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[18] The calculation of the price adjustment for Standard Flats did not include revenue forgone from the promotions. If the revenue forgone is included, then the price adjustment for Standard Flats is actually less than the average Standard Mail increase. *See* Section IV, *infra*.

purports to demonstrate that increasing the price of its underwater Standard Mail Flats product, relative to its highly profitable Standard Mail Letters product, would reduce contribution from the price adjustment available under the CPI cap in this docket. *See* Postal Service Library Reference USPS-LR-R2013-1/7. For the reasons explained below, that model is wholly without meaning or merit. In fact, Standard Mail price adjustments proposed by the Postal Service in this docket have failed to maximize contribution available under the price cap. *See* Section III.E, *infra*.

A. General Description of Postal Service Model.

The Postal Service presents six scenarios, contained in six separate Excel worksheets filed in USPS-LR-R2013-1/7, designated "Standard Mail Contribution Model." All six scenarios use the same set of fixed inputs, which are shown on lines 1-6 of the worksheet for each scenario. The six scenarios are divided into two sets, with the first set labeled 1a, 1b, and 1c, and the second set labeled 2a, 2b, and 2c.

Scenarios a, b, and c assume different percentage price increases, with the assumed price changes being identical as between scenarios 1 and 2. The percentage change in prices, shown on line 7 of each scenario, are as follows:

	Flats	Letters
Scenario a	2.570%	2.722%
Scenario b	4.570	2.229
Scenario c	2.000	2.863

Scenarios 1 and 2 differ only with respect to assumed exogenous trends in volume. In Scenarios 1a, 1b, and 1c, Standard Flats are assumed to be subject to a **7.0 percent declining** annual trend, while Standard Letters are assumed to be subject to a **4.0 percent increasing** annual trend. In Scenarios 2a, 2b, and 2c, both Standard Flats and Letters are assumed to have an annual volume growth rate of **2.7 percent**. By assuming the same annual volume growth rate, these latter three scenarios isolate the effect of price changes apart from exogenous volume trends.

Scenarios 1a, 1b, and 1c purport to illustrate that increasing the price of Standard Flats while holding down the price of Letters results in a reduced growth in contribution. Scenario 1b, which has the highest price increase on Standard Flats of the three scenarios, is alleged to result in a lower contribution than either Scenario 1a or 1c. A summary of the change in contribution in the six scenarios is shown in columns 4 and 5 of Table 3.

Table 3

Postal Service Assumed Percentage Change in Prices and Resulting Increase in Contribution (in millions)

	Percentage Change in Price			Increase in Contribution in	
	Flats (1)	Letters (2)	Total (3)	Scenario 1 (4)	Scenario 2 (5)
Scenarios 1a & 2a	2.570%	2.722%	2.692%	$518.7	$412.2
Scenarios 1b & 2b	4.570	2.229	2.692	513.8	412.2
Scenarios 1c & 2c	2.000	2.866	2.692	520.1	412.2

Source: USPS-LR-2013-1/7.

In the Postal Service model, percentage changes in the price of Standard Flats and Letters are not independent. They are linked so that the "Total" percentage change, shown in column 3 of Table 3, will be constant, at 2.692 percent (see column 3). Describing this model and the results shown in column 4 of Table 3, the Postal Service states:

> In contrast to the systemic decline of Flats, Standard Mail Letters grew by an annual average of 4 percent between FY 2009 and FY 2011. These divergent volume trends not only complicate the Postal Service's pricing decision, but also highlight **a natural tension** that exists within the Postal Accountability and Enhancement Act: the need to achieve 100 percent cost coverage (Factor 2) while maximizing revenue and contribution to achieve financial stability (Objective 5). Though these two aims are not always in conflict, the Commission's ACD Order **forces the Postal Service into a Hobson's choice** between compliance and generating additional revenue/contribution. As the model filed as USPS-LR-R2013-1/7 (**Contribution Model**) demonstrates, by applying a greater amount of price cap authority to Standard Mail Letters, the Postal Service could generate a greater amount of contribution.
>
> The Contribution Model presents six scenarios. In the first scenario **(1a)**, the Postal Service's proposed price increases for Letters and Flats are applied. The divergent volume trends are accounted for by applying a **7.0 percent reduction for Flats** and a **4.0 percent increase for Letters.** The result is a **$518.7 million** improvement in contribution. In the second scenario **(1b)**, the divergent volume trends are maintained, but more of the Postal Service's pricing authority is applied to Flats (4.57 percent price increase), while less is applied to Letters (2.229 percent price increase). In this case, contribution only increases by **$513.8 million**. Finally, scenario **1c** shows that, by applying additional pricing authority to Letters (2.863 percent) and less to Flats (2.00 percent), the Postal Service could generate even more contribution (+**$520.1**). [Notice, pp. 22-23 (footnotes omitted) (emphasis added).]

All three variations of Scenario 1 combine (i) the effect of arbitrarily postulated exogenous trends affecting volume, and (ii) assumed price changes. The exogenous trend used for Flats (–7.0 percent) is justified by the Postal Service as reflecting the trend over the last several years. The Postal Service Notice admits that "this trend appears to be accelerating, with flats volume declining by 8 percent year-to-date in 2012." (Notice, p. 21.) Indeed, over the first three quarters of FY 2012, on a year-to-year basis, the volume of Flats declined by

12.7 percent,[19] which exceeds the model's assumed trend by over 5 percent. The exogenous trend used for Letters (+4.0 percent) also differs from recent trends. For the first three quarters of FY 2011 and FY 2012, **Letters** volume **declined** by **7.8 percent** — from 37.9 to 35.0 billion pieces — reflecting a substantial **11.8 percent deviation** from the 4.0 percent growth trend used by the Postal Service. Moreover, the Postal Service projects that between FY 2011 and FY 2013 the volume of Letters will decline by 8.6 percent. Response to CIR No. 1, spreadsheet Standard Mail Flats Response to CIR No. 1, tab PCCM FY 11-13. Nevertheless, the Postal Service asks the Commission to rely on its model.

B. The Postal Service's Standard Mail Contribution Model Assumes that Demand for Products Is Totally Inelastic.

The Postal Service model implicitly assumes that neither Flats nor Letters exhibits any elasticity of demand whatsoever with respect to changes in price. The fact that zero elasticity is assumed is readily illustrated by comparing the volumes that result after applying the disparate price changes shown in Table 3, along with the assumed volume change occasioned by exogenous trends of –7.0 percent for Flats and +4.0 percent for Letters. Table 4 shows the resulting volumes.

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[19] This decline was from 5.105 to 4.459 billion pieces. *Compare* Public RPW Report for Quarter 3 YTD, Fiscal Year 2012 YTD *with* the Corresponding Period in Fiscal Year 2011 (Aug. 16, 2012; tab 2). http://www.prc.gov/Docs/84/84975/Letter_RPW_Q3_FY2012_20120816155921.pdf.

Table 4

Volume after Price Change and Exogenous Trend Effects
(Millions of dollars)

	Flats	Letters	Total
Scenarios 1a	5,710	49,532	55,241
Scenarios 1b	5,710	49,532	55,241
Scenarios 1c	5,710	49,532	55,241

Source: USPS-LR-2013-1/7, line 9 from each respective spreadsheet.

The price changes in the Postal Service's model (shown here in Table 3) are seen to have absolutely no effect on future volume (shown here in Table 4). Of course, this assumption of zero elasticity not only is extreme but also is unrealistic, especially in the current environment. Remarkably, elsewhere in its Notice, the Postal Service rejects its model's assumptions, stating that Standard Flats are **highly sensitive** to price increases:

> the Postal Service believes that **above average price increases** (though aimed at eliminating the cost coverage gap) could have the inadvertent effect of sending the Flats product **into a tailspin.** With each price increase, additional customers would be driven away…. [Notice, p. 22 (emphasis added).]

If an above-average price increase could send the volume of the Flats product "into a tailspin," as the Postal Service believes, then the demand for the Flats product is highly elastic, **totally contrary to what the Postal Service's model assumes.** Clearly, the Postal Service cannot have it both ways.

The PAEA price cap is computed in an exclusively "**backward-looking**" manner, in that only historical data from the most recent 12-month period are used.[20] But the effect of a price adjustment on contribution is necessarily **forward-looking**, which is what the Postal Service's Standard Mail Contribution Model purports to be.[21] However, although the Postal Service's Contribution Model is forward-looking, it ignores elasticity, generating data without any practical meaning or analytical utility.

If demand were totally inelastic, as assumed by the Standard Mail Contribution Model, the Postal Service could raise prices willy-nilly, with no effect on volume or profitability. That is obviously not the reality. Ignoring elasticity allows the Postal Service to avoid a fundamental difference between profitable and underwater products. For **profitable** products, **elasticity reduces** volume and **contribution** below what they would be if elasticity were zero. For **underwater** products, however, **elasticity** actually **increases contribution** by helping to reduce unprofitable volume.[22]

If the Postal Service truly believes that its Standard Flats product has a totally inelastic demand, as its model assumes, then it would have no excuse for not immediately increasing the

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[20] Inclusion of **projected** revenue foregone from planned promotional sales in the price-cap space could alter this. *See* Section IV, *infra*.

[21] Oddly, the Postal Service draws conclusions regarding future contribution from its Standard Mail Contribution Model, while admitting (in response to CIR No. 1, Q. 4c) that "the model is not intended to be 'after-rates.'" *See* further discussion at the end of this section.

[22] The Postal Service questions management's ability to capture cost savings from reduced unprofitable volume. Notice, p. 22. Valpak has more confidence than the Postal Service in its demonstrated ability to reduce costs which the Postal Service reports to be attributable, volume-variable costs. *See* Valpak discussion, Docket No. ACR2011, p. 62.

price of Flats to cover at least 100 percent of attributable cost. Alternatively, if the Postal Service believes that the Standard Flats product faces a demand that is less than totally inelastic, then both the Postal Service and the Commission should disregard totally any projection of contribution based on the Standard Mail Contribution Model in USPS-LR-2013-1/7 and replace it with a model that incorporates appropriate elasticities for the two products. *See* Section III.D, *infra*, for further discussion on this point.

Finally, in response to CIR No. 1, Q. 4c, the Postal Service was forced to admit that:

> The model is not intended to be "after-rates." No attempt was made to gauge the impacts of the prospective price increases on volumes (or to isolate those impacts) because own-price elasticities of demand are not available for flats and letters separately.

The Postal Service thus has acknowledged that its Standard Mail Contribution Model is not capable of gauging "the impacts of prospective price increases on volumes" — or on revenues or contribution, since volume directly affects each. Accordingly, the Postal Service admits that its model is wholly unable to measure changes in contribution under different scenarios — the very purpose for which it was offered.

C. The Assumptions Underlying the Postal Service Model Were Designed to Generate the Strange Results Obtained.

In each of the six Postal Service scenarios in the Standard Mail Contribution Model, the total contribution from Standard Flats is negative $590 million (*see* line 6). Because the Flats product is so far underwater, it also follows that any reduction in the volume of Flats — whether achieved by the exogenous volume trend of –7.0 percent or by a price increase and volume reductions caused by elasticity of demand — will reduce Postal Service losses and increase contribution. Indeed, if Standard Flats somehow were to disappear, then total contribution within Standard Mail would increase by the entire $590 million without changing the price of any other product.

Referring back to Scenario 1, it appears that giving Standard Flats an above-average increase, as in Scenario 1b, causes the increase in contribution to be reduced, as the Postal Service posits. What explains this counterintuitive result? Succinctly, the answer is that the reduction in Flats volume shown is caused by the exogenous trend of –7.0 percent.[23]

In Scenario 2, the three variations isolate the effect of price changes alone (but not elasticity). In Scenarios 2a, 2b, and 2c, the Postal Service sets the independent volume growth equal to 2.7 percent (*see* line 7 in each respective scenario), and the only factor that changes is price. In all three of these scenarios, the total change in contribution is $412.2 million (*see* line 14 of each respective scenario in USPS-LR-2013-1/7).[24] This equality of contribution makes perfectly good sense, at least mathematically and in terms of assumptions incorporated in the Postal Service model.[25] First, exogenous volume effects are eliminated. Second, since demand is unrealistically assumed to be totally inelastic, it then follows that changes in price

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[23] The Postal Service model's counter-intuitive result is attributable to the projected exogenous trends for Flats and Letters. The slight reduction in contribution shown in Table 3, *supra*, reflects the interaction between the change in price and the exogenous change in volume. When there is no exogenous trend, or the trend is assumed to be identical for Flats and Letters, as in Scenario 2, the difference disappears. *See* Table 3, column 5.

[24] This equality of the projected change in contribution within Scenario 2 is a tipoff that the assumed exogenous change in volume is the source of the counter-intuitive result concerning change in contribution.

[25] Of course, from an economic perspective the assumption of zero elasticity is completely unrealistic, as discussed in Section III.B, *supra*.

have no effect on volume. Third, because the model artificially links the prices of flats and letters so that the average price increase between these two products does not change, it stands to reason that neither total contribution nor the change in contribution will change. Viewed another way, as the Postal Service model increases the price of flats, the change in contribution increases by a significantly larger amount than the price increase, as shown in Table 5. There, in the second set of scenarios, the **price increase** in Scenario 2b is **2.25 times** the price increase in Scenario 2c (*i.e.*, 4.5 percent is 2.25 times 2.0 percent), yet the additional **contribution** increases **threefold** (*i.e.*, from $30 to $90 million).

Table 5

Change in Price of Standard Flats and Effect on Contribution

Price Increase on Flats	Scenario 1 (millions)	Scenario 2 (millions)
c. 2.000%	$ 83	$ 30
a. 2.570	95	43
b. 4.500	137	90

Source: Source: USPS-LR-2013-1/7.

D. Modification of the Postal Service's Standard Mail Contribution Model to Incorporate Postal Service Elasticity Estimates.

The Postal Service Standard Mail contribution model has been demonstrated to be of no practical or analytical value. A more realistic approach could begin with the Postal Service Standard Mail Contribution Model as a baseline, but then incorporate elasticity into the model. In January, 2012 the Postal Service submitted its most recent Demand Analysis and Volume forecast that contained elasticity estimates for all market dominant products. Former ECR products (which includes the Carrier Route and two High Density/Saturation products) were estimated to have an elasticity of –0.727, whereas demand for non-ECR products (which includes both the Standard Flats and Letters products) was estimated to be relatively more inelastic, at –0.286. In this analysis, however, those specific elasticities are ignored to show what happens generally in the Postal Service model as the elasticity of demand for Flats and Letters increases in steps over the range of zero to –0.6. *See* Section III.E, *infra* (discussion of elasticities contained in the most recent Demand Analysis and Volume forecast).

Table 6 illustrates the extent to which an increasingly elastic demand for Standard Flats and Letters reduces the increment in total contribution for each of the Postal Service's six scenarios. First, in every scenario, any elasticity (other than zero) means that an increase in price reduces the projected volume and revenue of every product. Second, in every scenario, increasing elasticity diminishes the contribution. Third, the two scenarios with the **highest increase in rates for Flats**, Scenarios 1b and 2b, have the **least diminution in contribution** as elasticity increases — *i.e.*, those two scenarios provide a **greater contribution**, not less, than the other scenarios. Scenario 1b has a contribution that is **slightly higher**, not less, even with a comparatively low –0.2 elasticity. At an elasticity of –0.6, the contribution from Scenario 1b is clearly far superior to Scenarios 1a or 1c. The same result holds for Scenario 2b. Thus, when the Postal Service model is modified to incorporate elasticity, a disproportionate increase in the price of Flats is seen to **increase contribution** over the other two scenarios, **not decrease it.** The Postal Service reference to Hobson's choice is an absurdity, and the "natural tension" which the Postal Service perceives between (i) achieving 100 percent cost coverage and (ii) maximizing contribution is a figment of its imagination.

Table 6

Increased Elasticity Reduces Change in Total Contribution
(Millions of dollars)

	Assumed Elasticity of Flats and Letters			
	(1)	(2)	(3)	(4)
	Zero	–0.2	–0.4	–0.6
Scenario 1a	518.7	496.3	473.8	451.4
Scenario 1b	513.8	497.7	481.6	465.5
Scenario 1c	520.1	495.8	471.5	447.2
Scenario 2a	412.2	391.3	371.3	349.4
Scenario 2b	412.2	399.8	384.5	369.3
Scenario 2c	412.2	391.3	367.5	343.7

Still using the Postal Service's Standard Mail Contribution Model, Table 7 isolates the effect of elasticity when the price of Standard Flats is increased. Regardless of the scenario, an assumption of any elasticity other than zero means that an increase in price reduces volume, as shown in Table 6.[26] And, since Standard Flats is so deeply underwater, any decrease in Flats volume reduces loss from Flats, which in turn helps increase contribution. Not surprisingly, the largest increase in contribution from Flats occurs in the two scenarios where

[26] "The Commission has continued to use the **elasticity-based** approach to estimating the response to marginal pricing incentives…. This **basic method** is an accepted analytical principle … that the financial impact of price incentives to increase mail volume or shift mail volume between products should be based on the Postal Service's **best estimate of the price elasticity**…." Docket No. R2009-5, Order No. 299, pp. 14-15 (emphasis added). Postal Service analysis should not omit elasticity effects, as it does in this docket.

Flats receive the largest price increase (Scenarios 1b and 2b). Significantly, as elasticity increases from zero to –0.6, contribution in these same two scenarios increases more than in the other two. For example, in Scenario 1b, with an elasticity of –0.6, contribution from the Flats component increases by $12 million (from 137 to 149), whereas in Scenarios 1a and 1c, contribution from the Flats component increases by only $8 and $6 million, respectively (see Table 7). Thus, although increased elasticity drives away volume and in every scenario and reduces contribution below the zero elasticity baseline in Table 6, the least diminution occurs in those two scenarios where Flats receives the highest price increase.

Table 7

Increased Elasticity Increases Change in Contribution from Standard Flats
(Millions of dollars)

	Assumed Elasticity of Flats and Letters			
	(1) Zero	(2) –0.2	(3) –0.4	(4) –0.6
Scenario 1a	95	98	100	103
Scenario 1b	137	141	145	149
Scenario 1c	83	85	87	89
Scenario 2a	43	46	49	52
Scenario 2b	90	94	99	103
Scenario 2c	30	33	35	37

In its response to CIR No. 1, question 4.a, the Postal Service states that it "does not believe that Flats and Letters are likely to have the same elasticity." The results demonstrated here are far more general and do not require a precise estimate of elasticity. Nor do they require that Flats and Letters have the same elasticity. They require only that these two postal products have **some** elasticity of demand. For example, assume that the demand for Flats is rather elastic, at –0.6, while the demand for Letters is rather inelastic, at –0.2, and call this combination Scenario 3. Alternatively, assume that the demand for Flats is rather inelastic, at –0.2, while the demand for Letters is rather elastic, at –0.6, and call this combination Scenario 4. Using the Postal Service's growth assumptions of Scenario 1, the contribution in Scenarios 3 and 4 is, respectively, $501.3 million and $446.3 million. In both of these two scenarios the contribution is less than it is with zero elasticity in Scenarios 1a, 1b, or 1c (Table 6, column 1). The greatest diminution is in Scenario 4, where Letters are assumed to have a high elasticity, which causes the price increase to drive away a greater volume of Letters, which are highly profitable. In all events, the Postal Service is better off financially as a result of larger increases in Standard Flats prices, totally contrary to Postal Service assertions.

E. Postal Service Pricing of Standard Mail Fails to Maximize Contribution and Is Arbitrary and Capricious.

Within each class of mail, the CPI cap places a strict limit on price increases, as well as the amount of additional revenue that the Postal Service can obtain. The CPI cap, 2.570 percent in this docket, times total revenue from the class during the most recent 12-month period, represents the maximum "allowable revenue" from each class.[27] (The Postal Service Notice refers to this maximum allowable revenue as its "precious cap space." Notice, p. 23.)

[27] In this docket, the Postal Service proposes a further increase in the maximum allowable revenue to take account of planned promotions. "The dollar value of the promotions, for purposes of the Standard Mail price cap compliance calculation, is estimated to be $19.5 million." Notice, p. 27. *See* discussion *infra*, in Section IV.

All additional revenue from a price increase on each and every product in the class counts towards the maximum allowable revenue for a class. The Postal Service may want to employ its much vaunted pricing flexibility to achieve a variety of objectives (such as extracting an increased penalty from its highest coverage Saturation products and transferring that penalty to a favored group of mailers — cataloguers). However, when the financial life of the Postal Service is on the line (*see* Section I, *supra*), the Commission should not restrict itself to a hands-off position and allow an irrational, infair, and financially dangerous path to be pursued.

At the same time, the various products within a class have different coverages and elasticities. For unprofitable products, the losses being suffered by the Postal Service decline as volume decreases, with each price increase driving away money-losing volume[28] — *i.e.*, reducing losses on Flats increases contribution. Conversely, for profitable products, the contribution that can be extracted from each dollar of allowable revenue declines with higher elasticity, because each incremental increase in price drives away profitable volume.[29] Consequently, in order to maximize additional contribution from each price adjustment, the Postal Service should seek to compute for each product a schedule showing the additional

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28 In its efforts to rationalize its pricing, the Notice states that "The Postal Service … must be careful not to make pricing decisions that will **artificially depress** Flats volume." *Id.*, p. 22 (emphasis added). Even as the Postal Service runs out of money, it does not seem to realize that its current practice maintains prices below cost, which **artificially inflates** volume.

29 Here again elasticity matters. To date, no postal product is estimated to have a price elasticity that exceeds 1.0 (in absolute value), but with continued growth of the Internet and mobile communications devices, that day may come. If the Postal Service someday has such a product, efforts to increase contribution through price increases on that product would be self-defeating. If costs cannot be reduced to a profitable level, the only rational option could be to exit the market for that product.

contribution per dollar of allowable revenue that is expected to result from each unit price increase.[30] This schedule needs to incorporate and reflect the elasticity for each product (which may be different for each product). For every product, the resulting schedule may be non-linear over the range of price increments that are possible within the cap. Once the relevant schedules are developed, maximum contribution requires that, as between the various products, when allowable revenue is at the cap, the additional contribution per dollar of allowable revenue be equal at the margin. When revenues from proposed changes in price are at the allowable cap and a change in the unit price of each product gives the same increase in contribution per dollar of allowable revenue utilized, price adjustments can be said to be "Pareto optimal" vis-a-vis contribution. That is, Pareto optimality occurs when total contribution will neither increase nor decrease as a result of trading off (i) a unit price change in one product and the allowable revenue which accompanies that price change against (ii) an equivalent change in the price and allowable revenue of any other product.

To illustrate, given the base year volumes, for each $0.001 increase in the price of Standard Flats and Letters the Postal Service gains (or uses), respectively, $6,137,349 and $47,643,301 of allowable revenue under the cap. Using the January 2012 elasticities of –0.286 for both Flats and Letters, for each $0.001 increase in price, the Postal Service gains, respectively, $6,505,000 and $40,840,000 of contribution. Dividing the gain in contribution by the respective allowable revenue, **for each dollar of cap space utilized by Flats, the Postal Service receives $1.06 in contribution, and for Letters the Postal Service receives**

[30] The prices of products in Standard Mail change in increments of $0.001.

$0.86 in contribution. These are the tradeoffs, at the margin, for rates proposed by the Postal Service in this docket for Flats and Letters. Clearly, giving up $1.06 of contribution from Flats in return for $0.86 from Letters does not maximize the contribution obtained from the Postal Service's "precious cap space."[31]

The Postal Service states that it does not believe that Standard Flats and Letters have the same elasticity.[32] Although the Postal Service does not say explicitly whether it believes the elasticity of Flats is greater or less than that of Letters, from its protective attitude toward pricing of Flats, one reasonably might infer that the Postal Service believes the demand for Flats is more elastic than it is for Letters. Clearly, some uncertainty exists with respect to the estimates of elasticity, and the Postal Service is entitled to its doubts — or beliefs. However, the Postal Service needs to recognize that if Flats are assumed to have a higher elasticity — *e.g.*, that of ECR products, –0.727 — then the marginal contribution from Flats for each dollar of allowable revenue increases from $1.06 to $1.15. If this higher elasticity for Flats is assumed to be case, then the Postal Service has opted for an even more unfavorable tradeoff — giving up a potential contribution of $1.15 from Flats in order to get $0.86 from Letters (and less from other Standard Mail products) — and is even further removed from the maximum contribution available to it under the cap. Choosing such unfavorable tradeoffs does **not** assure adequate revenue, retained earnings, and financial stability, nor does it comply with the

[31] For the three ECR products, the tradeoffs are even worse. For every $0.57 in contribution gained from the two High Density/Saturation products, the Postal Service forgoes $1.06 from Flats. For Carrier Route, the Postal Service gains $0.77 versus $1.06 from Flats.

[32] *See* Response to CIR No. 1, Q. 3.c-d.

mandate of section 3622(b)(5). Such choices are like a self-inflicted wound. They impair the ability of the Postal Service to enhance its contribution under the price cap. By quantifying tradeoffs within the available cap space, and using those tradeoffs systematically so as to maximize contribution, the mandate in section 3622(b)(5) can be seen to be just as quantitative as the other three statutory mandates on which Commission reviews have focused in rate adjustments to date.

With respect to the tradeoffs discussed here, the cap space is indeed precious. Unfortunately, the Postal Service continues to ignore these tradeoffs, and in so doing, digs itself into a deeper financial hole. Consequently, any effort by the Postal Service to maximize contribution within Standard Mail has failed miserably — not only in this docket, but also in all prior dockets under PAEA. The cumulative billions of dollars lost on Standard Flats, plus the countless dollars of contribution forgone by artificially increasing prices of more profitable products to cross-subsidize Standard Flats, illustrates clearly that Postal Service pricing has not served the company well.

Using the elasticity estimates submitted by the Postal Service in January 2012, it is submitted that its announced prices for Standard Mail fail to maximize contribution available under the price cap by a substantial amount, at least $71 million. Furthermore, if the Standard Flats product has an elasticity as high as ECR products (–0.727), as the Postal Service's "fears" seem to imply, the Postal Service will fail to achieve the maximum contribution available to it under the price cap by at least $86 million. Thus, of the additional contribution the precious cap space might have allowed the Postal Service to gain, it has "left on the table"

$71 million to $86 million[33] — 17 to 20 percent of the maximum available contribution that it could realize from this year's rate adjustment.[34]

The Postal Service has misused and squandered its precious cap space by needlessly proposing to increase prices on its more profitable Standard Mail products in order to continue nurturing its "loss-leader," Standard Flats. This strategy is especially astounding in light of the recently concluded docket approving the Valassis NSA. In that docket, extensive testimony by newspapers stated that Postal Service prices for High Density and Saturation Flats are not

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[33] These estimates of maximum contribution assume that the average price of Standard Flats is increased by $0.061, which is just under two-thirds the unit negative contribution of –$0.096. Even if the Postal Service somehow manages to reduce the unit cost of Standard Flats, such a price increase likely would leave coverage under 100 percent. The Notice inexplicably states that:

> the Postal Service's pricing decision for Flats was also influenced by the need to manage the **price gap** between Standard 5-Digit automation flats and Carrier Route flats. Had the Postal Service given a larger price increase to Standard Mail Flats, it would have been **forced to increase Carrier Route prices** (which are already increasing by 3.133%) **even further.** To avoid such an increase, which would have negatively impacted Carrier Route volumes, the Postal Service allowed the gap between these two products to grow from 8.2 cents to 8.3 cents. [*Id.*, p. 24 (emphasis added).]

Just why the Postal Service's oft-cited "pricing flexibility" requires such a fixed differential is not explained. In response to CIR No. 1, question 5, the Postal Service admits there is no legal reason that it is "forced" to increase Carrier Route prices in this fashion. In any event, the model for maximizing contribution used here does require any such fixed differential, and this self-imposed restriction was ignored. To the extent that some potion of the catalogue industry deserves to have prices ameliorated, it is the Carrier Route product which is more useful for prospecting than is Standard Flats. The maximum contribution here assumes an increase in the price of Carrier Route of only $0.007, substantially less than the increase proposed by the Postal Service.

[34] Valpak is developing a model from which one could develop optimal prices, and in the future would like to share its workpapers with the Commission or the Postal Service.

competitive with private delivery. Although testimony from opponents of the NSA might be dismissed as self-serving, the Postal Service's NSA partner, Valassis, also shares that view:

> Private delivery has always been less costly than mail, but in the past it suffered from a perception of inferior service and reliability. That has now changed. Private delivery has become much more sophisticated, employing modern technologies for managing delivery operations, including advanced software for delivery planning and routing, GPS systems for route mapping and real-time tracking, and delivery verification systems.... Private delivery programs are created and executed at distribution costs **well below** (up to 50 percent) the costs for mail at **current Saturation postal rates**.... Already, the **level of Saturation postal prices is too high to sustain current volumes.** [Docket No. R2012-8, Reply Comments of Valassis Direct Mail, Inc., pp. 6-8 (emphasis added).]

Moreover, the Postal Service itself not only acknowledged the diversion of newspapers' Total Market Coverage Mail to private delivery, but also implicitly agreed that its prices for High Density and Saturation Flats are not competitive:

> the Valassis NSA ... will benefit the marketplace by offering **more competitive pricing** with other private delivery alternatives.... [Docket No. R2012-8, Postal Service Reply Comments, p. 3 (emphasis added).]

It is long past time for the Postal Service to learn that its pricing adjustments need to send signals that support and encourage volume from the Postal Service's more profitable products, while discouraging products that are less profitable — especially products that are completely underwater and lose money on each piece mailed. Since the Postal Service has been stubbornly resistant to this truth, the Commission should use its supervisory authority to push the issue in this docket.

The Postal Service continues to assert that it is using its pricing flexibility under PAEA to pursue whatever it wants to do, even if it wants to employ an economically counterproductive pricing strategy. However, its pricing cannot be unfair and inequitable in violation of 39 U.S.C. § 101(d) as the Commission found it did. And, it goes almost without saying, however, that Postal Service pricing of Standard Mail products, especially the Standard Flats product, refutes any assertion that the Postal Service prices its products in an economically rational way so as to maximize contribution. To the contrary, the Postal Service appears to relish losing money on Flats while foregoing volume growth and higher contribution from its profitable products — with the Postal Service having lost over $2 billion on Standard Flats over the past four years, and perhaps another half-billion or so in the recently-ended FY 2012.

Clearly, Postal Service pricing strategies that harm other Standard mailers are not protecting the interests of taxpayers. Since taxpayers remain the nominal owners and obligors of the Postal Service, this raises a serious policy matter, one that extends far beyond pricing of Standard Flats and its continued hemorrhaging. It calls into question the rationale for (i) the increased pricing flexibility given to the Postal Service under PAEA, along with (ii) light-handed regulation by the Commission. Whether the Postal Service is unaware how to maximize contribution, or knows how but simply lacks the will to do so, the result is the same — each year a flawed price adjustment needlessly deepens the financial hole.

The Postal Service seems incapable of holding itself accountable and giving up its eleemosynary ways. Moreover, under light-handed regulation neither the regulator nor the regulated is clearly accountable for assuring "adequate revenues … to maintain financial stability." PAEA should not be interpreted to give the Postal Service pricing flexibility to destroy itself financially, or to unfairly burden taxpayers when it comes time for a bailout, or to reduce the role of the Commission to the point where it cannot help save the Postal Service from its misguided pricing strategy.

F. A Price Increase for Standard Flats that Is Less than Average Unit Cost Increases Is Unlikely to Improve Coverage.

The average revenue from Standard Flats in FY 2011 was $0.367. The purported "at class-average 2.570 percent rate increase" noticed for Standard Flats in this docket would increase average unit revenue by about $0.009, to $0.376. In justification of this meager price increase, the Postal Service Notice states that:

> The Postal Service maintains that the proposed prices for Flats and Letters represent a measured approach that will not only help capture additional revenue and contribution, but will also, over time, **move Flats toward 100 percent cost coverage.** [*Id.*, p. 21 (emphasis added).]
>
> [T]he Postal Service believes that the proposed price change sets Standard Mail Flats on a **sustainable path toward 100 percent cost coverage.** Indeed, the Postal Service estimates that Standard Mail Flats' cost coverage will modestly increase in FY 2012, and continue increasing in FY 2013. [*Id.*, pp. 24-25 (emphasis added).]

Since the Commission has established 100 percent cost coverage as the first goal for Standard Flats, the reasonableness of these unsupported assertions needs to be tested. Table 8 contains the average unit attributable costs for Standard Flats as reported in the CRA for Fiscal Years 2008 through 2011. As shown on the bottom row of Table 8, unit costs have increased, on average, by $0.025 per year since FY 2008. How additional revenue of under $0.01 per piece is going to help the Postal Service achieve 100 percent coverage of costs that have been increasing by more than double that amount is nowhere discussed.

Table 8

Unit Cost of Standard Flats
FY 2008 — FY 2011

Fiscal Year	Unit Attributable Cost (1)	Year-to-Year Increase (2)
2008	$0.389	
		$0.059
2009	0.448	
		0.000
2010	0.448	
		0.025
2011	0.463	
Total		$0.075
Average		$0.025

Source: CRA for each respective year.

The Postal Service's failure to give Standard Flats an above-average increase, and the failure of the Postal Service to explain how a 2.570 percent increase will achieve the Commission's minimum 100 percent goal, would fully justify a Commission conclusion that the Postal Service has deliberately refused to comply with the Commission's order.

If the Postal Service ever can find a way to reduce its costs of handling flats and achieve a coverage that exceeds 100 percent, the Postal Service and the Commission should keep in mind the massive cumulative losses incurred in nurturing this product. The Standard Flats product needs to begin making a quite substantial annual contribution in order to compensate for cumulative losses incurred to date. Even when coverage reaches 100 percent, the Postal Service needs to price this product to make a reasonable contribution to institutional costs (39 U.S.C. § 3622(c)(2)). It must set a realistic price now — well above current unit attributable cost — for handling this product.[35] The Postal Service needs to stop piling on avoidable losses.

G. Attributable Costs Are Volume Variable, and the Price of Standard Flats Should Be Increased to 100 Percent of Attributable Cost before Network Rationalization Is Complete, Not Afterward.

In FY 2011, the average revenue from Flats was $0.367, the attributable cost was $0.463 per piece, and the unit loss was $0.096. USPS-LR-R2013-1/7. To just achieve 100 percent cost coverage, average revenue would need to increase by $0.096, or approximately 25 percent.

To justify its defiance of the Commission's Order to increase the price and coverage, as well as reduce losses on the Standard Flats product, the Notice contains the following statement:

> Though [a decline in the volume of Flats] would not pose a significant problem if **processing costs** were **perfectly correlated** to volume, this is simply not the case. Given the **fixed** nature of processing equipment and the inflexibility of union contracts, processing costs would fall less quickly than volumes. Though the Postal Service continues to pursue operational efficiencies, such as Network Rationalization, it must be careful not to make

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[35] A reasonable target might be for the existing average revenue of $0.367 from Flats to provide a coverage of 134 percent, equal to that of Carrier Route (of the four profitable products in Standard Mail, Carrier Route is the least profitable). In order to achieve that target through cost reductions, the Postal Service would need to reduce the average cost of handling Flats by $0.190, from $0.463 to $0.273. In light of recent cost trends for Flats, this seems a tall order indeed.

> pricing decisions that will **artificially depress** Flats volume.
> [*Id.*, p. 22 (emphasis added).]

It is generally understood that mail processing costs do not change instantaneously and in perfect correlation with substantial changes in volume — hence the first part of the Postal Service's statement is applicable to virtually all postal products. With a significant increase or decrease in the volume of any product, it is not uncommon to find that longer-term adjustments to processing equipment and labor need to be made. The Postal Service has made such adjustments both to workforce and infrastructure as needed during its entire existence. However, short-term inflexibilities, such as those alluded to above, must not be used to override the calculation of volume-variable cost from the Postal Service's costing systems.[36]

Without the right to conduct discovery of vague statements such as this, one cannot be certain of the Postal Service's point. Conceivably, the Postal Service intends to challenge the accuracy of Postal Service-measured attribution and volume variability regarding Standard Flats costs.[37] If that is the Postal Service's intention, this docket is not the forum for such issues to be raised, especially by the Postal Service. Alternatively, the Postal Service simply may be saying that longer-term adjustments with respect to processing equipment and labor will be needed if volume predictably declines as the price of Flats is increased to cover attributable cost. If that is the meaning intended, then the Postal Service should get on with all the necessary cost cutting *post haste*, and not present its failure to have made such adjustments

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[36] *See* Docket No. R2006-1, USPS-LR-L-1.

[37] The Postal Service and the Commission recently agreed that, for Flats, "the cost data are reasonably accurate for rate making purposes." Periodicals Mail Study, Joint Report of the USPS and the PRC (Sept. 2011), p. 1.

as a theoretical obstacle to setting prices correctly and legally. Moreover, the losses incurred on the Standard Flats product in each of the four prior fiscal years show that the Postal Service should have increased the price of Flats much more and much sooner, just as any rationally operated business enterprise would have done. Had the Postal Service acted reasonably to stop the hemorrhage earlier, such large price increases would not be necessary now.

Regardless of what mistakes were made in the pricing of Standard Flats before, it is now time to increase prices substantially, even if there are uncertainties as to the precise effect on volume of such an increase. The demand for Standard Flats surely is not totally inelastic as assumed in the Standard Mail Contribution Model, nor is there any indication that it is anywhere close to being perfectly elastic. The Postal Service confesses uncertainty regarding the elasticity of demand for Flats. Postal Service Response to CIR No. 1, question 3.c-d. It could be –0.286 (fairly inelastic), as reported for non-ECR products, or –0.727 (inelastic, but considerably less so),[38] as reported for ECR products, or somewhere in between. Within this range, a 25 percent increase in the price of Flats reasonably could be expected to reduce volume by as little as 7 percent to as much as 18 percent. However, if a reduction in volume somewhere in this range is what is necessary in order to achieve **and maintain** cost coverage that is equal to or greater than 100 percent, increasing prices certainly should not be viewed as "**artificially**" depressing Flats volume.[39] After imposing such a long-delayed, much-needed,

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[38] This is the range indicated by the most recent Demand Analysis and Volume forecast of January 12, 2012.

[39] Indeed, pricing a product below cost will artificially maintain volume; *see* fn. 17, *supra*.

and Commission-ordered price increase on Flats, the remaining volume then would pay a price at least sufficient to cover 100 percent of attributable cost. It is in the Postal Service's own interest to learn sooner rather than later how many Flats will be entered at a price which exceeds attributable costs, particularly since the network is now being downsized.

As a result of the ongoing restructuring and downsizing of the network, many of the costs normally treated as fixed are subject to variation, as explained by several Postal Service witnesses in Docket No. R2012-1. It is most definitely not a reason to defer proper pricing, as the Postal Service argues. The sooner the Postal Service properly prices Standard Flats and learns how much the volume of Standard Flats in fact will be reduced when prices are increased to a sustainable level — *i.e.*, equal to or greater than attributable cost — the better. It would be far better for the Postal Service to learn now, while the network is in the process of being downsized and adjusted, rather than later, when further network retrenchment may be more difficult and costly. Now is a most appropriate time for the Postal Service to "bite the bullet" and redesign the network for a reduced volume of Flats that can afford to pay its full attributable cost. It makes no sense to restructure and redesign the network in a manner to incur extra costs to accommodate products with permanent on-going losses. PAEA requires the Postal Service to become a financially viable institution, which means "adequate revenues, including retained earnings, to maintain financial stability." This cannot and will not be achieved by pricing decisions that guarantee losses.

IV. THE POSTAL SERVICE'S USE OF REVENUE FORGONE FROM ITS PROMOTIONS TO INCREASE THE PRICE CAP DEPARTS FROM ESTABLISHED PRACTICE.

A. Using Discount Promotions to Offset Rate Increases Violates Commission Precedent for the Price Cap Calculation.

In this docket, for the first time under PAEA,[40] the Postal Service is claiming credit toward the price cap from some of the several temporary promotions it is offering mailers in 2013. The Postal Service's main explanation is as follows:

> Additionally, the Postal Service will seek to recover some of the revenue forgone from these promotions by factoring the lost revenue into the price cap calculation. A conservative estimate of the value of four of these promotions (Mobile Coupon/Click-to-Call, Emerging Technologies, Mobile Buy-it-Now, and Earned Value Reply Mail), based on historical data on qualifying volume, is approximately $33.4 million. The basis of this calculation is shown in the First-Class Mail and Standard Mail workpapers (USPS-LR-R2013-1/1 and 2). [Notice, p. 9.]

If the revenue forgone from these promotion were included, the Postal Service would have more room for price increases under the cap. Conversely, if the revenue forgone were excluded, total revenues from noticed Standard Mail prices would exceed the cap. Previously, the Commission has treated temporary promotions as having no impact on the price cap, analogous to Rule 3010.24, governing negotiated service agreements ("NSAs").

For example, in Docket No. R2009-3, the first "Summer Sale," the Postal Service treated the program "in a manner mathematically analogous to the procedure described in Rule 3010.24," and "essentially intends to ignore the effect of the price decrease resulting from the

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[40] In this docket, the Postal Service states that the promotions "were included for the first time in the cap calculation." USPS-LR-R2013-1/2, Tab "Description."

program on the price cap for both future and current prices." Docket No. R2009-3, Notice of Market-Dominant Price Adjustment (May 1, 2009), p. 8. The Commission determined that this analysis was "reasonable," as "[i]t shields mailers not eligible for the program from being charged higher rates based on the amount which otherwise would be banked from the program." Docket No. R2009-3, Order No. 219, p. 10. Using the same rationale, the Commission sanctioned this approach consistently in two subsequent dockets involving discounts for special promotions.[41]

In Docket No. R2011-1, the Postal Service proposed several discounts, including "Reply Rides Free" for First-Class Mail and a Saturation and High Density incentive. The Postal Service also proposed adjusting the threshold for the Move Update Assessment Charge. The Postal Service presented price cap calculations for the discounts, intending that the revenue forgone from the discounts could be banked for use in a general price adjustment at a later time. *See* Docket No. R2011-1, Notice of Market Dominant Price Adjustment (Nov. 2, 2010), pp. 7-9. The Commission rejected the Postal Service's proposed price cap approach, again validating the Postal Service's original treatment of the prior incentives and observing:

> Mailers that are not eligible to participate should not have negative consequences resulting from the incentive. Moreover, increasing unused rate authority could encourage the Postal Service to offer incentives that are otherwise unlikely to improve its financial condition. [Order No. 606, p. 19.]

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[41] *See* Docket No. R2009-5, Order No. 299, p. 9; Docket No. R2010-3, Order No. 439, p. 12 ("The Commission finds the proposed treatment is reasonable because ineligible mailers will not be charged higher rates based on the amount which otherwise would be banked from the program.").

Subsequently, in three other dockets involving promotions similar to the "Mail to Mobile" promotions in the instant docket, the Postal Service and the Commission treated the discounts as having no impact on calculation of the price cap. *See* Docket No. R2011-5, Order No. 731, p. 9; Docket No. R2012-6, Order No. 1296, p. 6; Docket No. R2012-9, Order No. 1424, p. 7.

Agencies are permitted to change position on a particular issue, but only with adequate explanation. The U.S. Supreme Court affirmed the principle that "An agency's view of what is in the public interest may change, either with or without a change in circumstances. But an agency changing its course must supply a reasoned analysis...." Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 57 (U.S.), quoting Greater Boston Television Corp. v. FCC, 444 F.2d 841, 852 (1970) (footnote omitted), *cert. denied*, 403 U.S. 923 (1971). In this docket, it is first the Postal Service's responsibility to "supply a reasoned analysis" for changing the applicability of Rule 3010.24, but the Postal Service has offered none.[42]

Given the short amount of time for consideration of the pricing changes noticed by the Postal Service, this docket is not the appropriate forum to consider policy changes such as permissibility of including revenue forgone in the price cap calculation. Such a change is more

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[42] Valpak generally has believed that reductions in general tariff rates are likely more effective in generating new and lasting volume than temporary promotions or NSAs.

suited to a separate rulemaking, as the Commission has stated in the past that it would initiate. *See* Docket No. R2011-1, Order No. 606,[43] p. 5.

B. The Postal Service Treats the Revenue Forgone Issue Inconsistently.

As the Postal Service explained in its Notice, it has **included** the revenue forgone from some promotions in order to recover it in the overall price increases at the **class** level for First-Class Mail and Standard Mail. However, revenue forgone is **excluded** in the Postal Service's calculation of average price increase for each **product**. This treatment is inconsistent.

Valpak believes that revenue forgone for temporary discounts should not be used to calculate the price change. *See* Section IV.A, *supra*. However, if the Commission allows the Postal Service to use revenue forgone in the price cap calculation, then logically, the revenue forgone should be included in the calculation of the average increases for the individual products as well.

Chairman's Information Request ("ChIR") No. 2, question 2, asked the Postal Service to "Confirm that percentage change in price by product does not include any of the revenue forgone from Mail to Mobile Promotions or the Earned Value Reply Mail Promotion." In response, the Postal Service stated: "The percentage change in price by product includes the revenue forgone from both the Mail to Mobile and Earned Value Reply Mail promotions." This statement from the Postal Service appears to be incorrect.[44]

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[43] http://www.prc.gov/Docs/71/71180/Order_No_606.pdf.

[44] ChIR No. 5, questions 1-5 seek further information on this discrepancy.

Postal Service Library Reference USPS-LR-R2013-1/2 provides a workpaper showing how the Postal Service reached its conclusion. The last tab ("Price Change Summary") of CAPCALC-STD-R2013.xls shows that the average price change for **Standard Mail** is 2.570 percent using weighted revenue at current prices and revenue at noticed prices. The sources of the revenue at the noticed prices (tab "LFP Revenue@New Prices," cell D147, and tab "HD-Sat-CR Revenue@New Prices," cell E118) are indeed **after** the revenue forgone is subtracted. However, the **Standard Mail product** calculations are performed separately, and the revenue forgone is never subtracted from any of the revenues before the calculation of the product increases. *See* tab "LFP Revenue@New Prices," cells D150-152 and E150-152, and tab "HD-Sat-CR Revenue@New Prices," cells E122-124 and F122-124.[45] If the revenue forgone from the Mail to Mobile promotions only is subtracted from Flats revenue, the percentage change for Standard Flats is 2.479 percent. Subtracting the revenue forgone from Earned Value Reply Mail would reduce this further.

The discussion in Section III, *supra*, is based on the assumption that the increases for the Standard Mail products as reported in Table 8 (p. 19) of the Postal Service's Notice are accurate — that the Standard Flats increase is 2.570 percent, the same as the overall average increase for Standard Mail of 2.570 percent. If the Commission approves the Postal Service's

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[45] The Postal Service's price change calculation for Carrier Route excludes the revenue from the new Carrier Route Parcels-Samples product. When included, the average price adjustment for Carrier Route increases from the reported 3.133 percent to 3.147 percent. *See* USPS-LR-R2013-1/2, CAPCALC-STD-R2013.xls, Tab "HD-Sat-CR Revenue@New Prices," cell E124.

use of revenue forgone in its price change calculations, then Standard Flats would appear to have a below-average increase yet again.

C. The Commission Should Not Depart from Established Practice in this Docket.

The Commission should not change in this pricing docket its now well-established practice to allow revenue forgone from the promotions to be included in the price cap calculation. This is not an appropriate forum to entertain significant rule changes. Interested parties have not been given adequate notice of this proposed change and do not have adequate time to comment, not do they have an opportunity to reply to comments of others.

Further, should the Commission nevertheless decide to allow inclusion in the rate cap of revenue forgone from special promotions, calculation of the individual **products'** price increases should reflect treatment of revenue forgone the same as with the **class**-wide price increase. In either event, the noticed increase for Standard Flats does not appear to be an above-average increase.

V. WORKSHARE DISCOUNTS.

A. Underwater Standard Flats Has Workshare Discounts over 100 Percent while Dropship Discounts for Saturation Are under 30 Percent.

The Postal Service Notice states that the Standard Flats product has "two [workshare] discounts that exceed 100 percent of avoided costs." The presorting discount is only slightly over 100 percent, and the Postal Service claims that discount is permissible under section 3622(e)(2)(B). Chairman's Information Request No. 3, question 1, asks the Postal Service for an explanation, but a response has not been filed during the preparation of these comments.

The Postal Service claims prebarcoding discount is permissible under section 3622(e)(2)(D), *i.e.*, that a reduction would "impede the efficient operation of the Postal Service." The current discount of 5.7 cents is slightly more than 200 percent of the cost avoided. However, the noticed discount is said to be increased to 7.5 cents, 326.1 percent of avoided costs. Notice, p. 44. The Postal Service's explanation for this large increase of the discount begs for further explanation: "The Commission will notice that this prebarcoding incentive was increased to 7.5 cents. This is not a strategic move from the Postal Service, but instead an inadvertent increase." Notice, p. 44. At this point, no information request seeking an explanation has been issued.

By contrast, High Density and Saturation Letters have drop-ship discounts that are about half of the cost avoided: 50.8 percent for DNDC Letters and 55.4 percent for DSCF Letters.

The Postal Service does not adequately explain why it offers discounts above cost avoided for a significantly underwater product like Standard Flats, and discounts well under cost avoided to highly profitable mail like High Density and Saturation Letters.

B. High Density Plus Should Not Be Treated as a Workshare Discount.

The Postal Service has added a new price tier into High Density and Saturation Letters: "High Density Plus." The only difference between the High Density and High Density Plus is an increased density threshold. The Postal Service Notice calls it a "workshare" discount, using Carrier Route letters as the benchmark price, but acknowledges that High Density and High Density Plus are priced independently from Carrier Route. ChIR No. 1 asks the Postal

Service to provide the information that is statutorily required to justify a new workshare discount.

Valpak certainly does not object to the new tier and the lower rate. However, Valpak believes that neither Saturation, High Density, nor High Density Plus constitutes a "workshare" discount, as density does not meet the definition of workshare in 39 U.S.C. § 3622(e). *See generally* Docket No. RM2009-3, Valpak Reply Comments (Sept. 11, 2009).

CONCLUSION

The Commission is faced in this docket with Postal Service noticed rates for Standard Flats which violate the Commission's own prior orders, beginning in Docket No. ACR2010. It is necessary for the Commission to reject those rates, and direct the Postal Service to file an amended notice increasing average Standard Flats rates substantially — by at least $0.05 — to begin to move that product toward 100 percent cost coverage over a two-year period. Of course, such rates for Standard Flats will use much of the Postal Service's price cap for Standard Mail, and therefore require adjustments to other noticed Standard Mail rates. For example, reductions in Saturation mail prices should generate additional highly profitable volume. Moreover, Commission rejection of the Postal Service's departure from the now-established method of treating revenue foregone from promotions without justification may require the Postal Service to modify its price cap calculations. However, there is no reason that the Postal Service could not notice lawful rate increases which could still go into effect with all Market Dominant rate increases on January 27, 2013. While the Postal Service is developing lawful Standard Mail rates, it should reconsider its widely disparate treatment of workshare discounts between unprofitable Standard Flats and profitable High Density/Saturation mail. To increase its chances for financial survival, the Commission should encourage the Postal Service to adjust prices to increase profitability for each class within the cap, and revising Standard Mail rates along these lines will be a significant step forward.

Respectfully submitted,

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